

Mark Weisbrot

Mark Weisbrot received his Ph.D. in economics from the University of Michigan, with specialization in international economics and political economy. He is author of "Globalization for Whom?" (Vol. 31, #3, 1998 Cornell International Law Journal) and co-authored "Writing the Constitution of a Single Global Economy : A Concise Guide to the MA1 (Multilateral Agreement on Investment)", (Washington, D.C. : Preamble Center, 1997).

He was a consultant to the Government of Haiti during the presidency of Jean-Bertrand Aristide. His most recent work is *Social Security: The Phony Crisis*, co-authored with Dean Baker (1999, University of Chicago Press).

He is currently Research Director at the Preamble Center, and a research associate with the Economic Policy Institute, both in Washington, D.C. His opinion pieces have appeared in the *Los Angeles Times*, the *Boston Globe*, the *San Francisco Chronicle*, the *Chicago Tribune*, and many other newspapers throughout the country. He has appeared on numerous television networks including CNN, PBS' Nightly Business Report, Fox News, and a variety of other talk shows.

RECENT PUBLICATIONS:

"Globalization for Whom?" (Vol. 31, #3, 1998 Cornell International Law Journal)

"Recent Experiences with International Financial Markets: Lessons for the Free Trade Area of the Americas," with Neil Watkins, (Washington, D.C.: Preamble Center/CIEL, 1999)

Social Security: The Phony Crisis, with Dean Baker (1999, University of Chicago Press)

"The Impact of the MAI on Employment, Growth, and Income Distribution" (Washington, D.C. : Preamble Center, 1997)

"Writing the Constitution of a Single Global Economy : A Concise Guide to the MAY, with Michelle Sforza and Scott Nova (Washington. D.C. : Preamble Center, 1997)

"Welfare Reform: The Jobs Arent There," (Washington, D.C. : Preamble Center, 1997)

"Unequal Sacrifice: The Impact of Changes Proposed by the Advisory Council on Social Security" (Washington, D.C. : Preamble Center, 1997)

"Structural Adjustment in Haiti," *Monthly Review*, Vol. 48, Number 8 (January 1997)

"Baltimore's Living Wage Law" with Michelle Sforza-Roderick, (Washington, D.C. : Preamble Center, 1996)

"The Logic of Contested Exchange," with Dean Baker, *Journal of Economic Issues*, December 1994.

"The Democratization of Haiti: A Question of Economic and Ecological Survival," with T. Anderson White, John Cavanagh, Josh Dewind, and John Hammock. Institute for Policy Studies (July 1994).

“The Political Economy of NAFTA,” with Thea Lee, paper presented at the January 1994 meetings of the Allied Social Science Association.

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Testimony of Mark Weisbrot to the United States Trade Deficit Review Commission, November 15, 1999

Thank you Mr. Chairman and members of the Commission. I would just like to make a few points that perhaps have not gotten the attention they deserve.

The U.S. trade deficit, through August of this year, has increased by about 58 percent over the same period last year. For 1999 we can expect a deficit of about \$250 billion in goods and services. About 80 percent of this deficit is with Asia.

A trade deficit of this size, currently running at about 2.8% of GDP, is not sustainable over the long term. Before turning to the causes of this problem, and possible solutions, it is worth addressing briefly some of the more common explanations.

It is most common to blame the trade deficit on America's low savings rate, and indeed this argument has been presented at previous hearings before this Commission. It is easy to show, as a matter of accounting, how this might occur: ignoring the government budget surplus, if domestic investment exceeds domestic savings, then we must borrow the difference from abroad, thereby running a trade deficit (see Appendix).

But accounting does not give us a mechanism of causality, and the assumption that it does is a common source of confusion in economics. The economists offering the above explanation state as though it were a fact that the causality runs from a low U.S. savings rate to a persistent trade deficit. But there is no reason to believe that this is true. Let's take a closer look.

In the standard "savings shortage" argument, the mechanism works like this: domestic investment exceeds domestic savings, and so domestic interest rates are driven up. This attracts the foreign savings necessary to make up the difference, but at the same time drives up the value of the dollar against foreign currencies. The result is a trade deficit (since the overvalued dollar makes our imports too cheap and our exports too expensive).

There are a number of assumptions that could be challenged in this logical sequence, but let's focus on one or two. First, it is necessary that the higher interest rates actually drive up the value of the dollar. But the relationship between U.S. interest rates (relative to the rest of the world) and the value of the dollar is empirically weak. There can be fairly big swings in the dollar without any corresponding movement in interest rates. To take the problem at hand: in 1996 the real (after inflation) interest rate on 30-year US treasury bonds was 3.4 percent. Today it is basically the same, just under 3.5 percent. Yet the dollar has appreciated by more than 16 percent against our major trading partners. (See Figures 1A and 1B.)

It is also important to remember that short-term interest rates are controlled by the Federal Reserve. Short-term rates can affect capital flows as much as long-term rates, and

are also a major determinant of long-term rates. So the other link in the “savings shortage” argument—between domestic savings (relative to investment) and interest rates—is even weaker.

You may recall that from the mid to late 80s until the early 90s it was very popular to argue that our large trade deficits then were actually *caused* by the federal budget deficit. This belief was popularized by leading economists at the nation’s most prestigious think tanks. But this “twin deficit” explanation is exactly the same argument that we are hearing today, except that now it is said that private spending, rather than government spending, drives up interest rates, the dollar, and hence the trade deficit. It’s exactly the same mechanism, and just as lacking in empirical evidence. You don’t hear much about the “twin deficit” theory any more—I *would* bet most of the economists who promoted it would like to forget that they ever said such things. Why? Well, first the trade deficit declined sharply (from its peak of 3.18% of GDP in 1986 to 0.35 percent of GDP in 1991), without a comparable decline in the budget deficit. (See Figures 1C and 1D.) The ensuing years buried the theory entirely: the budget deficit disappeared entirely into today’s surplus, while the trade deficit made a ferocious comeback to near-record levels. And of course the relation between government deficit spending and interest rates was also extremely *difficult* to find in the data.

All this should make us very suspicious of the idea that national savings, whether public or private, is driving the trade deficit. Remember that this “savings shortage”—like the budget deficits that were our prior scapegoat—can *only* affect the trade deficit by raising interest rates (and then the value of the dollar). Without a demonstrable empirical link between national savings and interest rates, the theory cannot hold.

There is a much simpler explanation for the overvaluation of the dollar, one that does not involve so many implausible links as the “savings shortage” thesis. Most importantly, we have had an enormous run-up in stock prices in recent years, the largest in American history. Price to earnings ratios are at twice their historic averages. A recent paper by Peter Diamond of M.I.T, one of the country’s leading macro-economists, estimates the market’s over-valuation at between 40 and 50 percent of current equity values.¹ Diamond’s analysis reiterates the work of Dean Baker, who demonstrated in a paper published two years ago that current stock prices were not sustainable, if we accept any of the standard growth projections for the coming *decades*.² In other words, today’s stock market has the markings of a classic speculative bubble, in which capital gains are based not on expectations of future earnings, but on expectations that further buying by others will continue to drive prices up.

This run-up has attracted a huge influx of foreign capital: the stock of foreign financial assets in the U.S. soared from under \$3 trillion in 1994 to more than \$5 trillion

¹ See Peter Diamond, “What Stock Market Returns to Expect for the Future?” Issue Brief no. 2, Center for Retirement Research, Boston College, September 1999.

² See Dean Baker, “Saving Social Security With Stocks: The Promises Don’t Add Up,” Century Foundation (formerly the Twentieth Century Fund), 1997

in 1998. It is easy to see how such an enormous surge in demand for dollar-denominated assets would drive up the value of the dollar.

The stock market bubble also helps explain the decline in the personal savings rate. Households that have accumulated large capital gains in their stock holdings (mostly in the upper income brackets) have seen no need to save out of **current** income, and have increased their consumption.

There are other forces that have helped to hold up the dollar: primarily, the perception in financial markets that the U.S. government is committed to a high dollar. Although that perception has weakened somewhat recently, Treasury Secretary Larry Summers has continued the policy of his predecessor Robert **Rubin**, and reiterated his support for a strong dollar. There was some concern in financial markets that Summers would pursue a different policy, because of his background as a highly renowned academic economist (in contrast to **Rubin's Wall Street experience**)—since most economists would favor allowing the dollar to decline. But so far the continuity at Treasury has been very strong.

The Fed's policy of keeping interest rates higher than necessary also boosts the dollar. Today's real, short-term Federal Funds rate of 2.65% is actually very high by historical standards. The Fed has raised interest rates twice in the last year, despite inflation running at 2.6% and little danger of acceleration; and as we speak today the Fed is considering another interest rate increase. Although the dollar is not an explicit concern of the Fed, its willingness to consider and implement policies that raise real interest rates in the absence of any significant inflationary threat undoubtedly contributes to the overvaluation of the dollar, and hence to the trade deficit.

I believe that this explanation of the trade deficit is more plausible and consistent with the evidence, especially the huge net foreign financial inflows, which have risen from an annual rate of less than \$200 billion in 1992 to \$500-800 billion over the last three years. By comparison, the "savings shortage" argument suffers from some extremely weak links and has nothing in the way of empirical evidence to back it up.

But whichever explanation you choose to believe, it should be clear that it is wrong to assert, as though it were a matter of simple economic logic, that our trade deficit is caused by a savings shortage. This is one possible explanation, and it is consistent with the basic identities of our national income accounts. But these accounting identities cannot be used to show causality, however much journalists and some economists may try to make them perform this task.



Another common explanation of our trade deficit is that the United States has shown surprisingly strong growth over the last few years. A country that grows faster than its major trading partners will generally face a worsening trade balance. This is because a nation's imports grow with the domestic economy, whereas export growth depends on the expansion of the country's trading partners. However, it is difficult to

construct a scenario in which the growth of foreign economies, relative to ours, could eliminate **our** trade deficit.

For example, imagine that, over the next few years, the economies of our major trading partners grew ten percentage points faster than the U.S. economy. This is an enormous **difference** in growth rates that is extremely unlikely. But even as an extreme case scenario, we would still have a trade deficit of more than \$150 billion. Clearly our trade deficit is not going to go away as a result of higher growth in the rest of the world. The dollar will have to decline, relative to the currencies of our major trading partners.

I would like to emphasize that this way of understanding the trade deficit has very different implications for policy than the “savings shortage” approach. While there are no known ways to cause people to increase their personal savings, there is quite a bit that policy makers can do with respect to the stock market bubble and the dollar. The value of both the stock market and the dollar are affected very much by what policy makers say and do. Fed Chairman Alan Greenspan has been concerned about the over-valuation of equities, and his statements on the subject have definitely had some influence. He has been more cautious about disturbing the markets since his “irrational exuberance” speech three years ago (the Dow was at 6500 then, as compared to more than 10,000 today), but clearly the Fed could help keep the bubble from expanding if it were to choose to do so. It could also inhibit speculative excess by raising the margin requirement for borrowing to purchase stocks. This could directly affect the demand for equities, and even if borrowers found other sources to get around an increased margin requirement, it would send a strong signal that the Fed is concerned about the over-valuation of equities. Margin debt has tripled since 1993, an enormous run-up in this type of borrowing. But the Fed has chosen instead to raise interest rates-twice since October of last year. This affects asset prices only very indirectly, by slowing down the economy. At the same time, raising interest rates helps maintain or increase the value of the dollar, worsening our trade deficit.

In sum, there is much that policy makers could do to reduce our trade deficit by lowering the value of the dollar-through both statements and actions, and by curbing speculative excesses in the stock market. But unfortunately our major policymakers seem more concerned with keeping the dollar **from** falling, which we would normally expect it to do in the face of such large and persistent trade deficits.



Finally, I would like to briefly describe another set of policy decisions that have contributed to the swelling of our trade deficit, particularly over the last two years, and especially with **Asia**.³ These are, first, our government’s contribution to the onset of the Asian financial crisis; second, the worsening of that crisis through policies designed by Treasury and the IMF; and third, the ongoing policy of encouraging exports and **export**-led growth by developing countries in Asia and throughout the world.

³ See also Mark Weisbrot, “Globalization for Whom?“, *Cornell International Law Journal*, Volume 3 1, Number 3. 1998

It is by now well documented that the proximate cause of the Asian financial crisis was the liberalization of capital flows that took place in the preceding **years**.⁴ This liberalization precipitated a huge capital inflow that was then suddenly reversed after the Thai baht began to fall in August of 1997. This reversal of net foreign capital flows was substantial: for the five hardest hit countries in the region (South Korea, Indonesia, Thailand, Malaysia, and the Philippines) it amounted to \$105 billion dollars, or 11% of these countries' GDP.

The policy changes that led to this volatility of international capital flows were foisted upon these countries by the U.S. Treasury department and the IMF. (Despite the fact that Europe and Japan could potentially outvote the United States in the IMF, they have never attempted to do so, and it is well known in international financial circles that the U.S. Treasury Department controls the Fund.) For example, an internal Treasury Department memorandum of June 29, 1996 listed "priority areas where Treasury is seeking further liberalization" in South Korea. These included the short-term foreign borrowing by Korean companies that set the stage for the panicked withdrawal.

When the Asian crisis began, the government of Japan tried to set up an Asian Monetary Fund to stabilize the region's currencies and obtained commitments from China, Taiwan, Hong Kong, Singapore, and other countries, for \$100 billion.⁵ This was before most of the worst currency crashes had occurred, and it is quite possible that much of the ensuing financial crisis could have been avoided if this plan had gone forward. It must be kept in mind that these economies were not bankrupt or in particularly bad shape. They were facing a liquidity crisis; what they needed more than anything else was an influx of foreign exchange reserves so that investors, who were fleeing domestic currencies and assets out of fear that their values would fall further, would stay put.

Larry Summers, then Deputy Secretary and now Secretary of the Treasury was quickly dispatched to the region to **kill** the plan for the Asian monetary **fund**, which he did. The U.S. Treasury Department wanted any bailout package to go through the IMF, where they could attach the conditions that they wanted. This is a good example of how Treasury's efforts to control the financial, industrial, and other economic policies of other countries can have a very harmful effect, and one which has boomeranged back on the United States, where the regional depression in Asia became the major contributor to the swelling of our trade deficit over the last two years.

I must emphasize this point because our government derives **support** for such policies from the argument that if we would only use our economic and political clout to bust open the Asian economies, we could reduce our trade deficit, and everyone would be better off. But here is a clear case where the American economy, as well as those of the

⁴ See, e.g., Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs*, May/June 1998; and Steven Radelet and Jeffrey Sachs, "The Onset of the East Asian Financial Crisis," Harvard Institute for International Development, March 30, 1998.

⁵ See, e.g., Paul Blustein, "Summit Stresses Trade, Leaving Bailouts to **IMF**," *Washington Post*, November 27, 1997

region hit by the crisis, would have done much better if these countries had been **left** to pursue their own regional economic solutions.

Unfortunately, the mistakes did not end **there**. Like a medieval doctor whose **first** recourse is to drain the “bad blood” **from** the patient, the Fund prescribed its usual medicine: high interest rates and a tightening of domestic credit to slow economic growth; fiscal tightening, including cuts in food and energy subsidies in Indonesia (later rescinded there after rioting broke out); and further liberalization of international investment-notwithstanding that this is what got these countries into trouble in the first place.

The Fund also made other serious mistakes, such as the closing of sixteen Indonesian **banks**, which led to panicked withdrawals that greatly destabilized the financial system. The one thing the IMF didn’t do, which was most necessary for stabilization, was to finance a roll-over of short-term lending into long-term credits.

The net result of all these errors was a deep regional recession, which of course cut sharply into US exports to the region. At the same time, the Fund and Treasury gave these countries no option but to try to export their way out of the crisis on the basis of undervalued currencies, thus contributing further to the US trade deficit.

Although these policies have been criticized by a number of prominent economists, there has been little indication from the Clinton administration of any need for change. Until that happens, we can expect that our top policy makers, as well as their allies in the IMF, will continue to contribute to the widening of our trade deficit.

Lastly, it is well known that the IMF, as well as its sister institution, the World Bank, encourages developing countries to produce for export. If you read through IMF and Bank-sponsored research on the efficacy of their structural adjustment programs and lending, for example, one of the main measures of the success of these policies is the growth of exports as a percentage of GDP. This encouragement for exports is also documented in letters of intent and other agreements that countries commit themselves to following in exchange for IMF loans.

From an economic point of view, there is no reason for a nation to favor exports over production for domestic markets. But these policy makers, and I must emphasize their close connection with our own government, have taken the textbook theory of comparative advantage to such an extreme that they believe that exporting, for these countries, is an end in itself. At the same time they seem to see the US market as the world’s buyer of last resort. So long as these institutions have the predominant voice in policy-making for most of the developing world, this will remain a significant source of pressure on the US balance of trade.

Let me conclude by saying that it would be a shame if we were to decide that our trade deficit were the result of the private savings or consumption habits of American households. All of the major contributing factors I have mentioned are either **policy-driven**, or where they are not-as in the case of foreign financial inflows due to

speculative bubble in equities—they can be greatly influenced by policy. What we need most of all is to recognize this, and to change our present policies so that our **persistent**—and at current levels, unsustainable—trade deficit can be reduced. ..

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APPENDIX

The standard accounting identity, from the national income accounts, is:

$$S - I = (G - T) + (X - M)$$

where

S = private savings

I = gross private domestic investment

G = government purchases of goods and services

T = taxes

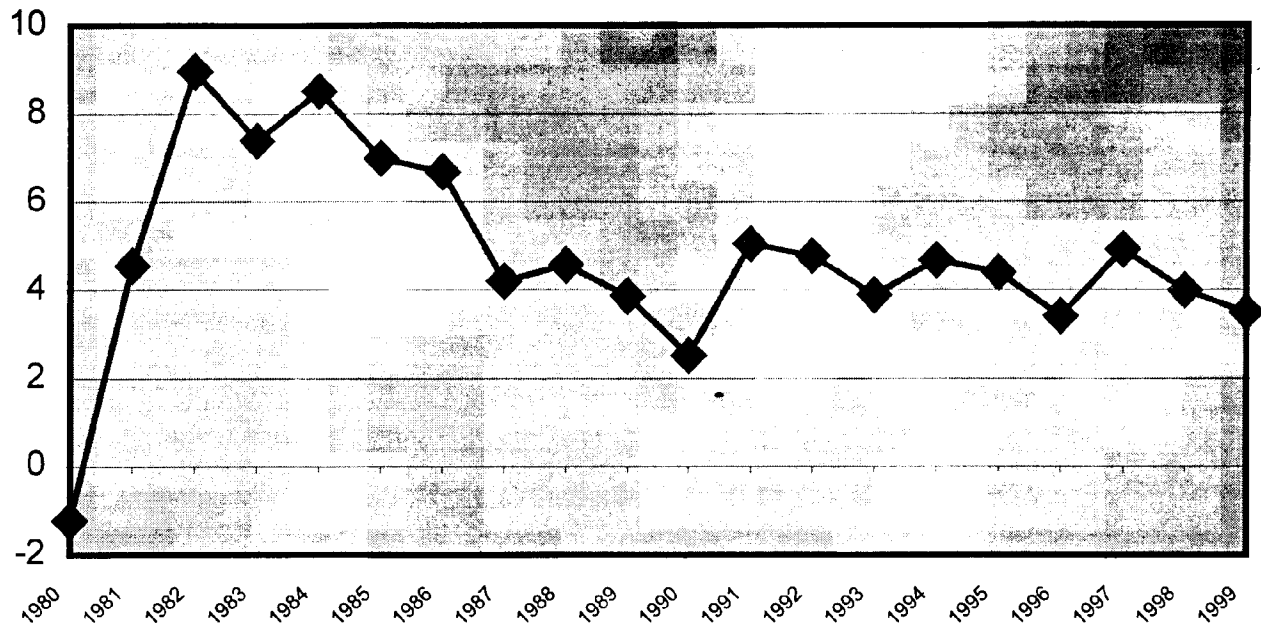
M = imports of goods and services

X = exports of goods and services

From this identity it is clear that if investment increases relative to savings, and the government budget deficit (G-T) remains the same, then the trade balance (X-M) must worsen. The same identity can also be used, as it was in the mid to late 1980s, to show that if the government budget deficit increases and there are no changes in S or I, the trade balance must also worsen.

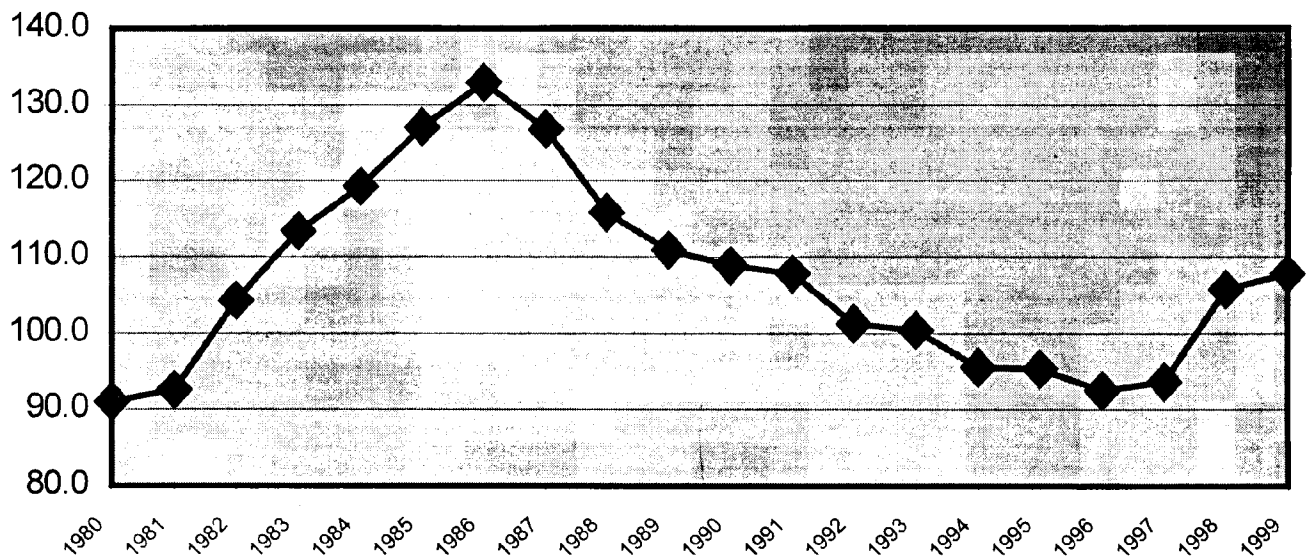
This accounting identity is often misused to state that the Federal budget deficit, or low private savings, has *caused the* trade deficit to increase. However, as explained in the text, the accounting identity itself says nothing about causality, and there are other, more plausible stories that are consistent with it: for example, a run-up in domestic stock market values can cause foreign financial inflows to swell, raising the value of the dollar (while causing households to save less), and worsening the trade balance.

Figure 1A: Real Interest Rate (30-year Treasury Bond)



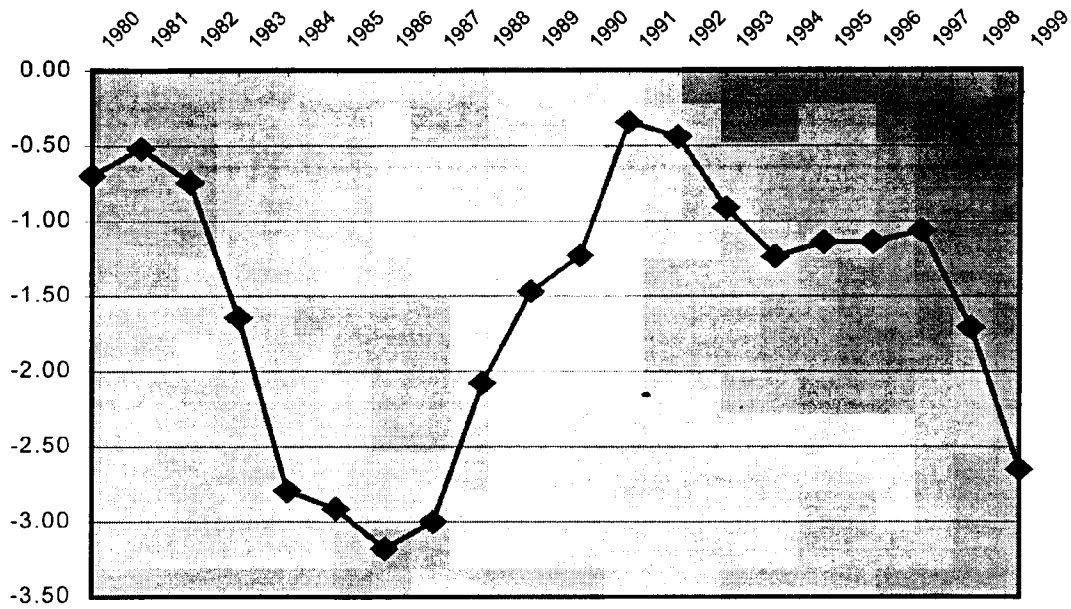
Sources: 1999 Economic Report of the President, Tables B-63 and B-73; Salomon Smith Barney; Bureau of Labor Statistics (<http://www.bls.gov/news.release/cpi.nws.htm>)

Figure 1B: Trade-Weighted Value of the U.S. Dollar (OITP index/March, 1973=100)



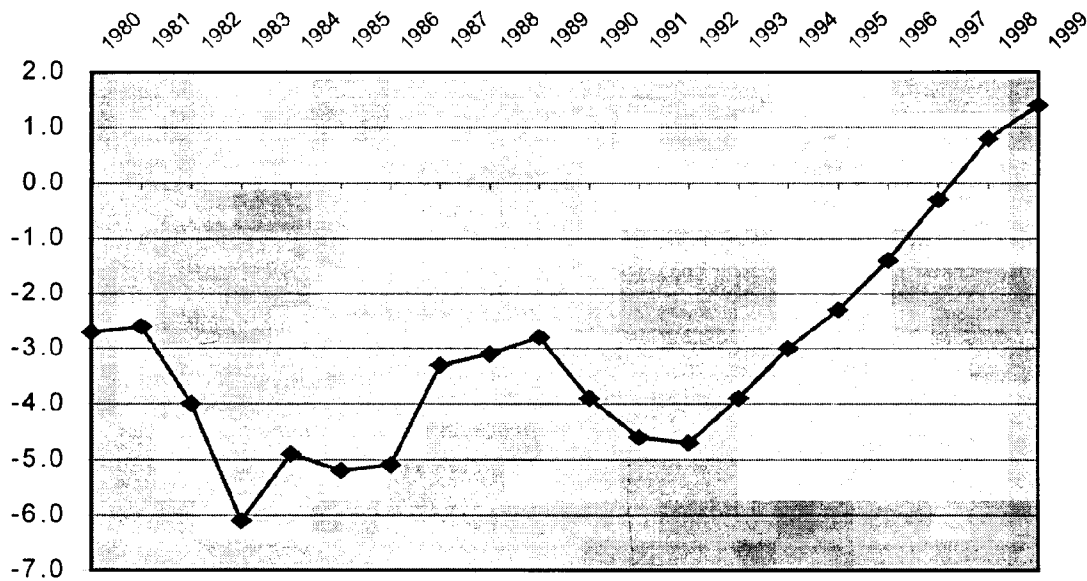
Sources: 1999 Economic Report of the President, Table B-110; Board of Governors of the Federal Reserve System (http://www.federalreserve.gov/releases/H10/Summary/indexoc_m.txt)

Figure 1C: U.S. Trade Deficit (Percent of GDP)



Sources: 1999 Economic Report of the President, Tables B-1 and B-103; Bureau of Economic Analysis (<http://www.bea.doc.gov/bea/newsrel/gdp399at.pdf>)

Figure 1D: Federal Budget Deficit (Percent of GDP)



Sources: 1999 Economic Report of the President, Table B-79; Year End Statement, Fiscal 1999, Secretary of the Treasury and Office of Management and Budget